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CORPORATE DIRECTOR AND OFFICER LIABILITY

Constance Frisby Fain*

I. INTRODUCTION

In the last ten years or so, there has been a deterioration of the rules that govern the conduct of corporate directors and officers, and other professional groups. New rules are emerging which affect the duties and liabilities of these professionals. Consequently, it has become difficult for directors and officers to anticipate the parties to whom they will be held liable for their own wrongful conduct and that of others.¹ Nevertheless, safeguards have developed for the benefit of directors and officers, such as indemnification statutes,² limitation on liability statutes,³ and statutes authorizing corporations to purchase and maintain director and officer liability insurance.⁴

Although there are many claims that may be brought against directors and officers by shareholders and others, such as fraudulent misrepresentation, federal security act violations, and RICO infringements,⁵ this article will focus primarily on tortious misconduct, specifically professional negligence and other tort causes of actions. This article addresses the scope of duty, breach, causation, and damages; the various types of director and officer misconduct that give rise to actions against them; and the diverse defenses and protective devices that may defeat or limit director and officer malpractice claims.

II. DEFINITIONS AND ROLES OF CORPORATE DIRECTORS AND OFFICERS

A corporate director is a person who has been "appointed or elected according to law, [and is] authorized to manage and direct the affairs of a corporation or company. The whole of the directors collectively form the board of directors."⁶ A corporate officer is one who occupies an office

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1. Kirsten L. Thompson, *Liability of Professionals, Officers, and Directors: Annual Survey*, 28 TORT & INS. L.J. 376 (1993) [hereinafter Thompson, *Liability of Professionals*].

2. A discussion of indemnification statutes follows *infra* VII.A. See also Theodore D. Moskowitz & Walter A. Effross, *Turning Back the Tide of Director and Officer Liability*, 23 SETON HALL L. REV. 897, 902-23 (1993) [hereinafter *Turning Back the Tide of Director and Officer Liability*].

3. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 912-17.

4. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 917-23.

5. 18 U.S.C. §§ 1961-1968 (1994). See also *infra* part VI.G.

6. BLACK'S LAW DICTIONARY 460 (6th ed. 1990). A director may be classified as an

"which . . . [is] provided for in the corporate charter, such as president, treasurer, etc., though in a broader sense the term includes vice presidents, general manager and other officials of the corporation."⁷ A corporation is "an artificial person or legal entity created by or under the authority of the laws of a state."⁸

Despite the corporate directors' comparable fiduciary responsibility to the corporation and its shareholders, some courts hold officers to a higher degree of care than directors.⁹ The reason for this difference in the required degree of care relates to the roles each plays in connection with the corporation. The functions of the officers are to manage the corporation, to oversee day-to-day operations, to prepare reports pertaining to financial and other matters, and to prepare and analyze data to be presented to the board of directors.¹⁰ On the other hand directors in large publicly held corporations usually function as advisors to management and formulators of corporate policy. Furthermore, the board of directors relies on the various reports prepared by the officers. In a small corporation, directors exercise considerable control over corporate operations.¹¹

III. STATISTICAL DATA

There has been a significant increase in the number of law suits filed by shareholders against directors and officers. For instance, one study

inside or outside director. An *inside director* "is an employee, officer or major stockholder of [the] corporation." *Id.* An *outside director*, on the other hand, is a "non-employee director with no, or only minimal, direct interest in [the] corporation." *Id.* By comparison, the standard of care applicable to inside directors has been held by the courts to be higher than that of the outside director because the inside director's involvement in the day-to-day operations of the corporation is greater. Thus, there is an inference

that inside directors have more knowledge and awareness of the management of the corporation. Conversely, outside directors have less time to devote to the daily operations of the corporation. . . . As a result of their lack of time to become involved in the details of the corporation's business, outside directors act in more of an advisory capacity, functioning in "a more general decisionmaking and supervisory role."

Marcia M. McMurray, Note, *An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 605, 620-21 (1987) [hereinafter McMurray, *An Historical Perspective on the Duty of Care*].

7. BLACK'S LAW DICTIONARY 340 (6th ed. 1990).

8. *Id.*

9. McMurray, *An Historical Perspective on the Duty of Care*, *supra* note 6, at 619 & n.85 (citing *Raines v. Toney*, 228 Ark. 1170, 313 S.W.2d 802 (1958)). The *Raines* court stated that "[t]he law imposes a high standard of conduct upon an officer or director of a corporation." *Raines*, 228 Ark. at 1178, 313 S.W.2d at 808.

10. McMurray, *An Historical Perspective on the Duty of Care*, *supra* note 6, at 619-20.

11. McMurray, *An Historical Perspective on the Duty of Care*, *supra* note 6, at 619.

revealed that shareholder actions against directors are escalating twenty to twenty-five percent each year despite the fact that laws are generally more favorable to boards of directors. Furthermore, Jim Newman, publisher of a newsletter that addresses securities class actions, reported that plaintiffs prevail in eighty to ninety percent of the cases by obtaining favorable judgments or settlements.¹²

Directors and officers have also experienced difficulty in procuring liability insurance coverage. The cost of insurance has increased considerably even though more things are excluded from coverage. Policy durations have lessened, resulting in thirty, sixty, or ninety day coverage in many instances.¹³ Furthermore, deductibles have increased, policies are more vulnerable to early termination, and coverage is not available at all for some corporations.¹⁴

IV. SCOPE OF DUTY AND BREACH

For about two-and-a-half centuries, courts have attempted to determine the nature and standing of corporate directors and officers in order to define their obligations.¹⁵ It was ultimately decided that directors and officers are "fiduciaries who have a 'distinct legal relationship' with the corporation."¹⁶ In their capacity as fiduciaries, directors and officers must comply with duties of care and loyalty acknowledged and dictated by the courts since around 1742.¹⁷

This fiduciary duty that directors and officers owe to the corporation, shareholders, and others¹⁸ comprises two components: a duty of care and a

12. *Life in the Boardroom*, 1990 MGMT. REV. 16 (1990).

13. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 900 & n.15.

14. *Special Project: Director and Officer Liability*, 40 VAND. L. REV. 600, 602 (1987).

15. See McMurray, *An Historical Perspective on the Duty of Care*, *supra* note 6, at 605-06.

16. McMurray, *An Historical Perspective on the Duty of Care*, *supra* note 6, at 606. See also Constance Frisby Fain, *Professional Liability*, 5A PERSONAL INJURY: ACTIONS, DEFENSES, DAMAGES 135 (1991) [hereinafter C. Fain, *Professional Liability*]. A fiduciary is "[a] person having [a] duty, created by his undertaking, to act primarily for another's benefit in matters connected with such undertaking . . . [;] a person having duties involving good faith, trust, special confidence, and candor towards another." BLACK'S LAW DICTIONARY 625 (6th ed. 1990). A fiduciary duty requires one "to act for someone else's benefit, while subordinating one's personal interests to that of the other person. It is the highest standard of duty implied by law." *Id.*

17. McMurray, *An Historical Perspective on the Duty of Care*, *supra* note 6, at 606. See also, e.g., *Charitable Corp. v. Sutton*, 2 Atk. 400, 406, 26 Eng. Rep. 642, 645 (1742) (holding that "fidelity and reasonable diligence" are required of a corporate director).

18. Thompson, *Liability of Professionals*, *supra* note 1, at 385. See also, e.g., Harman

duty of loyalty.¹⁹ Directors and officers may invoke the business judgment rule, which has traditionally been treated with flexibility by most courts, to safeguard their conduct.²⁰

A. Duty of Care

In a majority of states, the duty of care owed by directors and officers to the corporation and its shareholders²¹ is "the duty to exercise 'the care an ordinarily prudent person in a like position would exercise under similar circumstances.'"²² The reasonable prudent person standard has been applied to directors in several cases.²³

v. Willbern, 374 F. Supp. 1149 (D. Kan. 1974) (holding that under Kansas law, a director, who was a trustee, was not liable for the financial losses of a loan and investment corporation), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); Eagle Properties, Ltd. v. Scharbouer, 807 S.W.2d 714 (Tex. 1990) (holding that no fiduciary duty was owed by bank directors to partnership creditor where the creditor alleged negligence of bank directors in carrying out professional obligations).

19. Thompson, *Liability of Professionals*, *supra* note 1, at 385.

20. Thompson, *Liability of Professionals*, *supra* note 1, at 385.

21. See, e.g., Raines v. Toney, 228 Ark. 1170, 1178, 313 S.W.2d 802, 808 (1958) ("The law imposes a high standard of conduct upon an officer or director of a corporation . . . [because] he has voluntarily accepted a position of trust and has assumed the control of [the] property of others."); Graham v. Allis-Chambers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) ("[T]he question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him."); Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985) (upholding imposition of liability on corporate director because of sufficient proof of gross negligence on his part); Boeing Co. v. Shrontz, No. 11273, 1992 WL 81228 (Del. Ch. Apr. 20, 1992) (noting that assertions of neglect and waste fall within duty of care claims against directors and officers).

22. Thompson, *Liability of Professionals*, *supra* note 1, at 385 & n.32 (citing REVISED MODEL BUS. CORP. ACT § 8.30 (a)(2)(1984)). See also FDIC v. Stanley, 770 F. Supp. 1281, 1310 (N.D. Ind. 1991) ("[T]he degree of care to which . . . directors are bound is that which ordinarily prudent and diligent men would exercise under similar circumstances."), *aff'd sub nom.* FDIC v. Bierman, 2 F.3d 1424 (7th Cir. 1993). Cf. *In re Farmers Co-Op of Ark. and Okla.*, 53 B.R. 600, 602 (W.D. Ark. 1985) ("[F]ailure of a director to exercise diligence or good faith resulting in a loss, may result in directors' liability for the loss.").

23. See, e.g., FDIC v. Greenwood, 739 F. Supp. 450 (C.D. Ill. 1989); Harman v. Willbern, 374 F. Supp. 1149 (D. Kan. 1974) (applying Kansas law), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); Smith v. Citation Mfg. Co., 266 Ark. 591, 587 S.W.2d 39 (1979); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) (stating the standards for an action based on director neglect); Department of Banking v. Colburn, 198 N.W.2d 69 (Neb. 1972).

Corporate officers are normally generalists whereas directors are expected to possess special knowledge, competence, and skill in view of the specialized position that they hold. Thus, in the case of a director,

Arkansas courts apply a higher standard of care than most other states. In a leading case on the subject, *Raines v. Toney*,²⁴ the Arkansas Supreme Court held that corporate directors, by virtue of their voluntary acceptance of a position of trust and authority over others' property are held to a high standard of care.²⁵ Where a person is both an officer and a director of a corporation, the applicable standard of care has been determined to be even higher than that imposed upon persons in a fiduciary relationship.²⁶

B. Duty of Loyalty

The conduct requirement under the duty of loyalty, which is the second component of the traditional fiduciary duty, parallels that which is required under the duty of care. The duty of loyalty obligates the director and officer to "act at all times in the best interests of the corporation and its shareholders and not engage in self-dealing."²⁷ Total loyalty to the interests of the corporation and its shareholders is crucial and necessary;²⁸ therefore, in addition to self-dealing, bad faith and fraud on the part of an officer or

[a]s a general rule, a director should acquire at least a rudimentary understanding of the business of the corporation. Accordingly, a director should become familiar with the fundamentals of the business in which the corporation is engaged. . . . If one "feels that he has not had sufficient business experience to qualify him to perform the duties of a director, he should either acquire the knowledge by inquiry, or refuse to act."

Francis v. United Jersey Bank, 432 A.2d 814, 821-22 (N.J. 1981). See also Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 951 (1990). [hereinafter Eisenberg, *The Duty of Care*].

Arkansas imposes a higher standard of care—even higher than the standard owed in a fiduciary relationship—upon corporate officers who are also directors. See *Raines*, 228 Ark. at 1178, 313 S.W.2d at 808.

24. 228 Ark. 1170, 313 S.W.2d 802 (1958).

25. "The law imposes a high standard of care on an officer or director of a corporation . . . [because] he has voluntarily accepted a position of trust and has assumed the control of property of others." *Id.* at 1178, 313 S.W.2d at 808.

26. See, e.g., *Hall v. Staha*, 314 Ark. 71, 79, 858 S.W.2d 672, 676 (1993) ("As officers and directors, [the appellants] are held to an even higher [standard] than the normal and demanding standards that apply to a fiduciary.") (citing *Raines*, 228 Ark. at 1178, 313 S.W.2d at 808).

27. Thompson, *Liability of Professionals*, *supra* note 1, at 385. See, e.g., *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 264 (2d. Cir. 1984). Self-dealing is when one acts "out of self-interest when one should be acting in the interest of another." WILLIAM STATSKY, WEST'S LEGAL THESAURUS/DICTIONARY 684 (1985) [hereinafter WEST'S LEGAL DICTIONARY]. For instance, self-dealing "exists where [a] person in a fiduciary or confidential relationship uses property of another for his own personal benefit." BLACK'S LAW DICTIONARY 1359 (6th ed. 1990).

28. See, e.g., *Lacos Land Co. v. Arden Group, Inc.*, 517 A.2d 271, 278 (Del. Ch. 1986). See also Jay W. Eisenhofer, *Officers' and Directors' Liability under Delaware Law*, THE BRIEF, Summer 1993, at 65, N.4 [hereinafter Eisenhofer, *Officers' and Directors' Liability*].

director are also recognizable claims based on the breach of the duty of loyalty.²⁹

Arkansas follows the common-law approach in determining the duty of loyalty. In an early case, *Bank of Commerce v. Goolsby*,³⁰ the Arkansas Supreme Court held that the duties owed by corporate directors to their shareholders "in the absence of any statute, . . . must be ascertained and controlled by common law rules applicable generally to such relations and powers."³¹ Arkansas courts have also extended this duty to creditors of the corporation.³² The duty owed by Arkansas corporations and corporations that are licensed to do business in Arkansas is quite broad. However, perhaps as a trade-off, neither an individual nor a creditor may bring an action against a corporate officer or director for a breach of fiduciary duty—the right to pursue such an action is specifically reserved for the corporation, unless otherwise provided by statute.³³

C. The Business Judgment Rule

The business judgment rule is a judicially-created presumption that "in making a business decision the directors . . . acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."³⁴ Consequently, boards of directors are protected

29. See, e.g., *Colorado Mgmt. Corp. v. American Founders Life Ins. Co.*, 359 P.2d 665 (Colo. 1961); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Shlensky v. South Parkway Bldg. Corp.*, 166 N.E.2d 793 (Ill. 1960); *Simpson v. Spellman*, 522 S.W.2d 615 (Mo. Ct. App. 1975). See also Eisenhofer, *Officers' and Directors' Liability*, *supra* note 28. The court in *Pogostin v. Rice*, 480 A.2d 619 (Del. 1984), stated that "[d]irectorial interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders." *Id.* at 624, quoted in Eisenhofer, *Officers' and Directors' Liability*, *supra* note 28, at 65.

30. 129 Ark. 416, 196 S.W. 803 (1917) (holding that the common-law duties imposed on natural persons in a fiduciary relationship apply with respect to corporate officers and directors and the shareholders). See also *In re Ozark Restaurant Equip. Co.*, 41 B.R. 476 (W.D. Ark. 1984), *cert. denied sub nom.* *Sacoway v. Anderson*, 484 U.S. 848 (1987).

31. *Goolsby*, 129 Ark. at 416, 196 S.W. at 809.

32. *Goolsby*, 129 Ark. at 438-39, 196 S.W. at 809. The federal courts in Arkansas have also recognized the State's rules of law concerning the duty of loyalty. In *In re Farmers Co-Op of Arkansas & Oklahoma*, 53 B.R. 600 (E.D. Ark. 1989), the district court noted that Arkansas courts have imposed a fiduciary duty on corporate directors "to the creditors and shareholders of the corporation to exercise control of and [to] manage the affairs of the corporation." *Id.* at 602 (citing *Goolsby*, 129 Ark. at 416, 196 S.W. at 803).

33. See *Red Bud Realty v. South*, 153 Ark. 380, 396, 241 S.W. 21 (1922). See also *Robertson v. White*, 633 F. Supp. 954 (W.D. Ark. 1986) (noting that Arkansas courts have consistently held that the exclusive right against officers and directors resides in the corporation unless statutes provide otherwise).

34. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), quoted in *Turning Back the Tide*

from second guessing by the courts because of the presumption that they have acted in good faith and complied with their fiduciary duties of care and loyalty.³⁵

The evolution of the business judgment rule occurred contemporaneously with the development of the duty of care concept.³⁶ Although individual courts have pronounced their own versions of the business judgment rule, the rule essentially provides that "if any rational business purpose exists for the directors' or officers' decisions, they are not liable for errors in judgment when their decisions result in an unfavorable outcome for

of *Director and Officer Liability*, *supra* note 2, at 898.

Note that the business judgment rule does not provide "protection for directors who have made 'an unintelligent or unadvised judgment.'" *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

One writer has described the rationale upon which the business judgment rule is based in the following manner:

First, by recognizing human fallibility, the rule encourages competent individuals to assume directorships. Second, the rule recognizes that business decisions frequently entail risk, and thus provides directors the broad discretion they need in formulating dynamic and effective company policy without fear of judicial second-guessing. The rule "recognizes that shareholders to a very real degree voluntarily undertake the risk of bad business judgment; investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers." Third, the rule keeps courts from becoming enmeshed in complex corporate decision-making, a task which they are admittedly ill-equipped to handle Finally, the rule ensures that directors rather than shareholders manage corporations.

Turning Back the Tide of Director and Officer Liability, *supra* note 2, at 898 n.6 (quoting DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 6-7 (3d ed. 1989)). Furthermore, courts have acknowledged problems with judicial review of corporate decisions. One court stated:

[A]fter-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later because business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.

Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983), *quoted in Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 899 n.6.

For additional cases criticizing the judicial review of corporate decisions *see, e.g.*, *International Ins. Co. v. Johns*, 874 F.2d 1447, 1458 n.20 (11th Cir. 1989) (applying Florida law); *Starrels v. First Nat'l Bank*, 870 F.2d 1168, 1174 (7th Cir. 1989) (Easterbrook, J., concurring) (applying Delaware law), *cited in Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 899 n.6.

35. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 898. *See also Eisenhofer, Officers' and Directors' Liability*, *supra* note 28, at 65.

36. *See McMurray, An Historical Perspective on the Duty of Care*, *supra* note 6, at 613; C. Fain, *Professional Liability*, *supra* note 16, at 136.

the corporation."³⁷ With respect to the substantive quality of a director's or officer's decision-making function, there are three elements that comprise conditions for the application of the business judgment rule: (1) a decision must have been made by the director or officer;³⁸ (2) the director or officer must not have stood to gain personally from the subject matter of the decision;³⁹ (3) the director or officer must have exercised informed judgment in making the decision in that he was "reasonably informed" regarding the decision.⁴⁰

In making an informed judgment, a director or officer has an obligation to make a reasonable investigation of the corporation's business and affairs. A good faith belief in, or reliance upon, information provided by other experts, attorneys, capable and knowledgeable inside officers, or other external consultants is proof of a director's or an officer's adherence with the duty of care.⁴¹

Arkansas's business judgment rule is statutory.⁴² Arkansas courts have addressed the application of the standard of conduct for directors set out in this statute and have stated that "[t]he rule is a rebuttable presumption that directors are better equipped than the courts to make business judgments and that the directors acted without self-dealing or personal interest and exercised reasonable diligence and acted with good faith [in fulfilling their duties]."⁴³

In determining whether the business judgment rule applies, Arkansas courts employ a two-prong test to determine the appropriateness of applying the above stated presumption to a corporate director or an officer. First, the court inquires as to whether the director or officer is disinterested and whether his conduct meets the statutory definition of business judgment.

37. McMurray, *An Historical Perspective on the Duty of Care*, *supra* note 6, at 614. See, e.g., *Otis & Co. v. Pennsylvania R.R.*, 61 F. Supp. 905, 911 (E.D. Pa. 1945), *aff'd*, 155 F.2d 522 (3d Cir. 1946); *Casey v. Woodruff*, 49 N.Y.S.2d 625, 642-43 (Sup. Ct. 1944).

It has been expressed that "[t]he business judgment rule serves to uphold the decisions of a board which acts 'on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.'" *NCR Corp. v. AT&T Co.*, 761 F. Supp. 475, 491 (S.D. Ohio 1991), *quoted in* Thompson, *Liability of Professionals*, *supra* note 1, at 386.

38. See Eisenberg, *The Duty of Care*, *supra* note 23, at 959 & n.38 (citing A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 (c) cmt. c (Tent. Draft No. 4, 1985)).

39. A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 (c) cmt. d.

40. *Id.* § 4.01 (c)(2). Reasonable diligence is presumed to have been used in making the decision. See, e.g., *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357, 384 (2d Cir. 1980); *Casey v. Woodruff*, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944).

41. Thompson, *Liability of Professionals*, *supra* note 1, at 386.

42. ARK. CODE ANN. § 4-27-830(a) (Michie 1991).

43. *Smith v. Leonard*, 317 Ark. 182, 190, 876 S.W.2d 266, 270-71 (1994) (citing *Hall v. Staha*, 303 Ark. 673, 678, 800 S.W.2d 396, 399 (1990)).

Second, the court must determine whether the director or officer exercised reasonable diligence in informing himself of all relevant information reasonably available at the time the decision was made.⁴⁴ Once the director makes this showing, his actions are presumed to be in accordance with the acceptable standard in business judgment, and the burden of showing otherwise shifts to the complaining party.⁴⁵

In making an informed judgment, a director or an officer has an obligation to make a reasonable investigation of the corporation's business and affairs. A good faith belief in or reliance on information provided by other experts, attorneys, capable and knowledgeable inside officers, and other external consultants is proof of a director's or an officer's adherence with the duty of care.⁴⁶ For example, in *NCR Corp. v. AT&T Co.*,⁴⁷ the court considered a board of director's decision to approve a new employee stock ownership plan implemented in an effort to defeat a competitor's takeover. The business judgment rule failed to insulate the board of directors from judicial inquiry because a completely informed decision had not been made. Specifically, the board failed to request a "fairness opinion," failed to examine thoroughly the tax and accounting changes, failed to consider state law, failed to consider available employee stock ownership plan options, failed to follow corporate procedure for adopting such a plan, and failed to consider other data. In other words, the board failed to comply with the requisite duty of care.⁴⁸

Another case,⁴⁹ involving the business judgment rule concerned a shareholder's derivative suit brought on behalf of a corporation against the board of directors. The claimants alleged mismanagement of corporate assets and breach of fiduciary duty. The court refused to defer to the special litigation committee's recommendation that the corporation not pursue the action against the board. The court's position was that the investigation upon which the committee's investigation was based failed to satisfy the requisites of a complete and reasonable inquiry. Consequently, the defendants were not entitled to deference under the business judgment rule, and their motion for summary judgment was denied.⁵⁰

44. *Smith*, 317 Ark. at 190-91, 876 S.W.2d at 271.

45. *Id.*

46. Thompson, *Liability of Professionals*, *supra* note 1, at 386.

47. 761 F. Supp. 475 (S.D. Ohio 1991).

48. *NCR Corp.*, 761 F. Supp. at 491-95 (S.D. Ohio 1991), *cited in* Thompson, *Liability of Professionals*, *supra* note 1, at 386-87.

49. *Davidowitz v. Edelman*, 583 N.Y.S.2d 340 (Sup. Ct. 1992), *aff'd*, 612 N.Y.S.2d 882 (App. Div. 1994).

50. *Id.* at 344, *cited in* Thompson, *Liability of Professionals*, *supra* note 1, at 387.

The decision-making authority of directors was seriously diminished in *Smith v. Van Gorkom*⁵¹ wherein the court confirmed the view that "the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one."⁵² Therefore, the court reversed the trial court's application of the business judgment rule in favor of the defendant directors.⁵³

The business judgment rule has been evaluated and recognized in cases involving the duty of a passive director to act upon knowledge of the illegal conduct of a fellow director who actively participated in the violation of a statute,⁵⁴ the fiduciary duty of a director to make an informed judgment before responding to merger or tender offers,⁵⁵ and suits involving directors' and officers' good faith in making decisions in general.⁵⁶

Since the mid-1980s, there has been some deterioration of the business judgment rule. Elevated judicial interference has threatened the traditional

51. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). *Smith* involved a shareholders' class action suit against a corporation seeking either rescission of a cashout merger of the corporation and a wholly-owned subsidiary of the corporation or, in the alternative, damages from the corporate board. *Id.* at 863. The court held that the directors breached their fiduciary duty to the corporation's shareholders

(1) by . . . [the directors'] failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the Pritzker merger; and (2) by their failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker offer.

Id. at 893.

52. *Id.* at 873.

53. *Id.* at 893.

54. *See, e.g., Geygan v. Queen City Grain Co.*, 593 N.E.2d 328 (Ohio Ct. App. 1991). The *Geygan* court found a breach of duty by the passive director of the corporation, and thus held that he was not entitled to insulation under the business judgment rule. *Id.* at 333.

55. *See, e.g., Treadway Cos. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980) (applying New Jersey law); *Enterra Corp. v. SGS Assocs.*, 600 F. Supp. 678 (E.D. Pa. 1985); *Harriman v. E.I. DuPont de Nemours & Co.*, 411 F. Supp. 133 (D. Del. 1975); *Dasho v. Susquehanna Corp.*, No. 65-C-1757, 1970 WL 237 (N.D. Ill. Feb. 6, 1970) (applying Illinois law), *aff'd in part, rev'd in part*, 461 F.2d 11 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972); *Selama-Dindings Plantations, Ltd. v. Durham*, 216 F. Supp. 104 (S.D. Ohio 1963) (applying Ohio law), *aff'd*, 337 F.2d 949 (6th Cir. 1964); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Pogostin v. Rice*, 480 A.2d 619 (Del. 1984); *Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985); *Doyle v. Union Ins. Co.*, 277 N.W.2d 36 (Neb. 1979).

See also Robert Roy, Annotation, *Duty of Corporate Directors to Exercise "Informed" Judgment in Recommending Responses to Merger or Tender Offers*, 46 A.L.R.4th 887 (1986 & Supp. 1995) [hereinafter Roy, Annotation].

56. *See, e.g., Sam Wong & Son, Inc. v. New York Mercantile Exch.*, 735 F.2d 653, 677 (2d Cir. 1984); *In re RJR Nabisco, Inc. Shareholders Litig.*, No. 10389, 1989 WL 7036 (Del. Ch. Jan. 31, 1989) (applying Delaware law).

protection afforded director and officer decision-making.⁵⁷ Still the plaintiff's burden of overcoming the rule's presumption of due care and loyalty becomes almost insurmountable if the court finds that the rule applies to the conduct of the director or officer being sued.⁵⁸ In fact, the successful application of the business judgment rule effectively exonerates directors from liability for conduct that does not amount to a conflict of interests, self-dealing, gross negligence, or fraud.⁵⁹ Some courts appear to favor the application of the business judgment rule over the conventional duty of due care analysis.⁶⁰

In brief, one writer has noted that due to the erosion of the business judgment rule, a new rule may be emerging—"a management or directorial duty to guarantee corporate success."⁶¹ The parties to whom this duty is expected to apply may even include the general public or "unforeseen persons impacted by a corporation's conduct."⁶²

D. Breach of Duty

Although a corporate director or officer is generally bound to use due care in carrying out his professional obligations to others, there can be no negligent or wrongful conduct unless there is a breach of common law or statutory duties. Where directors have not utilized available information

57. *Turning back the Tide of Director and Officer Liability*, *supra* note 2, at 897.

58. Eisenhofer, *Officers' and Directors' Liability*, *supra* note 28, at 65, 68 n.2 (citing AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986)).

59. See McMurray, *An Historical Perspective on the Duty of Care*, *supra* note 6, at 615, 617-18. See also Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971), *aff'd*, 332 A.2d 139 (Del. 1975); Gimbel v. Signal Cos., Inc., 316 A.2d 599 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974).

60. See McMurray, *An Historical Perspective on the Duty of Care*, *supra* note 6, at 615. For judicial treatment see, e.g., Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757 (2d Cir.), *cert. denied*, 464 U.S. 1018 (1983); Lewis v. Curtis, 671 F.2d 779 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982); Shivers v. Amerco, 670 F.2d 826 (9th Cir. 1982); Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259 (3d Cir.), *cert. denied*, 439 U.S. 1129 (1978); Burton v. Exxon Corp., 583 F. Supp. 405 (S.D.N.Y. 1984) (applying Delaware law); Whittaker Corp. v. Edgar, 535 F. Supp. 933 (N.D. Ill. 1982) (applying Delaware law); Maher v. Zapeta Corp., 490 F. Supp. 348 (S.D. Tex. 1980) (applying Delaware law); Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706 (N.D. Ill. 1969) (applying New York law); Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Gruenberg v. Goldmine Plantation Inc., 360 So. 2d 884 (La. Ct. App. 1978); Gimpel v. Bolstein, 477 N.Y.S.2d 1014 (App. Div. 1984); Nursing Home Bldg. Corp. v. DeHart, 535 P.2d 137 (Wash. Ct. App. 1975).

61. Thompson, *Liability of Professionals*, *supra* note 1, at 390.

62. Thompson, *Liability of Professionals*, *supra* note 1, at 390. Note that this emerging trend may be limited by other state laws, such as Arkansas's rules concerning who has standing to bring an action against a corporate director or officer. Cf. *supra* note 33 and accompanying text.

before arriving at a decision, courts have found a breach of duty.⁶³ Conversely, where directors have availed themselves of essential, relevant information prior to making a decision, courts have found no breach of duty.⁶⁴

Regarding corporate waste and mismanagement, courts may impose liability on directors when they negligently allow officers and employees to mismanage or supervise the corporation's affairs.⁶⁵ Where directors erroneously rely upon officers or employees, courts may decline to hold directors liable for harm caused by officers' and employees' defalcations, poor supervision, or mismanagement of corporate affairs. Since the reliance upon officers or employees is merely erroneous, there is usually no liability imposed for errors of judgment engendered by neglect or breach of duty.⁶⁶

Arkansas courts have held that a breach of duty that results in any loss to the corporation may result in liability.⁶⁷ Such liability may be imposed without regard to whether the breach was intentional⁶⁸ or unintentional.⁶⁹

63. See, e.g., *FDIC v. Stanley*, 770 F. Supp. 1281 (N.D. Ind. 1991) (focusing on the liability of interested directors versus noninterested directors for breach of the duty of care), *aff'd sub nom.* *FDIC v. Bierman*, 2 F.3d 1424 (7th Cir. 1993); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Doyle v. Union Ins. Co.*, 277 N.W.2d 36 (Neb. 1979); *Geygan v. Queen City Grain Co.*, 593 N.E.2d 328 (Ohio Ct. App. 1991) (focusing on the duty of a passive director to act upon becoming aware of a fellow director's active violation of the law). See also *Roy*, Annotation, *supra* note 55.

64. See, e.g., *Treadway Cos. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980) (applying New Jersey law); *Harriman v. E.I. DuPont de Nemours & Co.*, 411 F. Supp. 133 (D. Del. 1975); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Pogostin v. Rice*, 480 A.2d 619 (Del. 1984). See also *Roy*, Annotation, *supra* note 55.

65. See, e.g., *Index Fund, Inc. v. Hagopian*, 417 F. Supp. 738 (S.D.N.Y. 1976); *Liberty Nat'l Bank & Trust Co. v. Foster*, 737 S.W.2d 704 (Ky. Ct. App. 1987); *Taylor v. Alston*, 447 P.2d 523 (N.M. Ct. App. 1968); *Maxey v. Rodman*, 444 S.W.2d 353 (Tex. Civ. App. 1969). See also J.F. Rydstrom, Annotation, *Liability of Corporate Directors for Negligence in Permitting Mismanagement or Defalcations by Officers or Employees*, 25 A.L.R.3d 941 (1969 & Supp. 1995) [hereinafter *Rydstrom*, Annotation].

66. See, e.g., *FDIC v. Boone*, 361 F. Supp. 133 (W.D. Okla. 1972). See also *Rydstrom*, Annotation, *supra* note 65.

67. *In re Farmers Co-Op of Ark. & Okla.*, 53 B.R. 600, 602 (W.D. Ark. 1985).

68. See, e.g., *Hall v. Staha*, 303 Ark. 673, 681-82, 800 S.W.2d 396, 401 (1990) (holding that director could be held liable for instituting a "double billing" procedure that might subject the corporation to actions in the future); *Raines v. Toney*, 228 Ark. 1170, 1180, 313 S.W.2d 802, 890 (1958) (holding that corporate fiduciaries cannot, while still employed, start a competitive enterprise or resign and take with them key personnel of their corporations for the purpose of operating a competing business).

69. See, e.g., *Lane v. Chowning*, 610 F.2d 1385 (8th Cir. 1979) (imposing liability on directors for the mismanagement of the bank president despite their reasonable belief that the president was honest and competent); *Bank of Commerce v. Goolsby*, 129 Ark. 416, 196 S.W. 803 (1917) (imposing liability on bank directors for the unsupervised acts of a teller that resulted in a loss to the bank); *Bank of Des Arc v. Moody*, 110 Ark. 39, 116 S.W. 134 (1913) (holding directors liable for losses bank incurred due to cashier's actions that were

V. CAUSATION AND DAMAGES

As in all professional negligence cases, causation and damages must be proved in order to subject the defendant director or officer to liability for negligent conduct. The corporation must sustain a loss, and a causal connection must exist between the defendant's breach of duty and the loss. Consequently, a defendant director's or officer's neglect of duties concerning corporate affairs must be a cause in fact and a legal or proximate cause of the harm sustained by the corporation, its shareholders, creditors, or others who may have claims against the defendant. Furthermore, the resulting harm must be the normal, natural, and probable consequence of the defendant's breach of duty.⁷⁰

VI. CORPORATE DIRECTOR AND OFFICER LIABILITY REGARDING VARIOUS MALPRACTICE CLAIMS

Malpractice actions against corporate directors and officers are frequent and varied. Regardless of whether such actions are based on professional negligence or some other civil misconduct, it is evident that litigation involving directors, officers, corporations, stockholders, and other relevant parties will continue to grow. Claims by stockholders against directors and officers are often in the form of a class action⁷¹ or a derivative suit. Whether a claim is categorized as derivative or direct is based on the allegations of the complaint, not how the claim is labeled by the plaintiff.⁷² A derivative suit has been defined as "a claim brought by a stockholder suing on behalf of the corporation to redress injury inflicted directly on the

not discovered by the directors who were negligent in running the bank).

70. See generally Rydstrom, Annotation, *supra* note 65, §§ 15-16.

71. A class or representative action is:

[a] device by which a suit can be instituted by or against numerous persons whose interests are sufficiently common that the dispute involving all of them can be litigated in one action without joining everyone. One member of the class (the named representative) represents everyone. Before a class action is allowed, the court must be convinced that the class, although ascertainable, contains so many persons that it would be impracticable to bring them all before the court. It must also be clear that there is a well-defined commonality of interest among the group in the questions of law and fact involved in the dispute. Finally, the named representative must demonstrate that he or she will fairly and adequately represent everyone.

WEST'S LEGAL DICTIONARY, *supra* note 27, at 137.

"This procedure is available in federal court and in most state courts The trial court must also certify the lawsuit as a class action." BLACK'S LAW DICTIONARY 249 (6th ed. 1990).

72. Eisenhofer, *Officers' and Directors' Liability*, *supra* note 28, at 66.

corporation itself,"⁷³ such as an alleged depletion of corporate assets or a decline in stock value.⁷⁴ Conversely, an individual suit may be brought by a stockholder seeking "damages if he or she alleges 'special injury,' which has been construed as a breach of a stockholder's contractual rights."⁷⁵ If the stockholder prevails in his derivative suit, the recovery belongs to the corporation because the harm was inflicted directly on the corporation.⁷⁶

A. Liability Regarding Duty of Care in Making Public Statements

Claims may be brought against directors or officers for making overly optimistic statements and failing to correct prior public statements. Therefore, if a director or officer makes an overly positive statement without revealing significant company problems, thereby misrepresenting the well-being of the business, then the corporation, the directors, and the officers could be held liable based on negligent misrepresentation, fraud, or federal securities violations.⁷⁷ Similarly, if a corporation and its officials fail to correct previous public statements concerning the condition and prospective performance of the business, the investors may have a claim for federal securities violations.⁷⁸

An interesting case arising out of Arkansas does not directly address the issue of civil liability, but it does suggest that the Arkansas courts may, in a proper case, impose liability for negligently making public statements. In *United States v. Little Rock Sewer Committee*,⁷⁹ the federal government brought criminal charges against the five-member sewer committee, charging that the committee publicly declared the proposed sewer plan complied with federal statutes when, in actuality, it did not.⁸⁰ The court found that the committee's knowledge of the falsity at the time the statement was made

73. See *Lipton v. News Int'l*, 514 A.2d 1075, 1078 (Del. 1986), cited in *Eisenhofer, Officers' and Directors' Liability*, *supra* note 28, at 68 n.16.

74. See *Eisenhofer, Officers' and Directors' Liability*, *supra* note 28, at 68 nn.18-19 (citing *Kramer v. Western Pac. Indus.*, 546 A.2d 348, 353 (Del. 1988); *Cede & Co. v. Technicolor, Inc.* 542 A.2d 1182, 1188 (Del. 1988); *Bokat v. Getty Oil Co.*, 262 A.2d 246, 249 (Del. 1970); *In re Tri Star Pictures Litig.*, No. 9477, 1990 WL 82734 (Del. Ch. June 14, 1990); *Elster v. American Airlines*, 100 A.2d 219, 222 (Del. Ch. 1953)).

75. *Eisenhofer, Officers' and Directors' Liability*, *supra* note 28, at 66, 68 n.17 (citing *Cede & Co. v. Technicolor*, 542 A.2d 1182, 1188 n.10 (Del. 1988)).

76. See *Kramer v. Western Pacific Indus.*, 546 A.2d 348, 351 (Del. 1988), cited in *Eisenhofer, Officers' and Directors' Liability*, *supra* note 28, at 66, 68 n.21.

77. See *In re Adobe Sys., Inc. Sec. Litig.*, 767 F. Supp. 1023 (N.D. Cal. 1991), cited in *Thompson, Liability of Professionals*, *supra* note 1, at 389.

78. See *In re Meridian Sec. Litig.*, 772 F. Supp. 223 (E.D. Pa. 1991), cited in *Thompson, Liability of Professionals*, *supra* note 1, at 389 & n.52.

79. 460 F. Supp. 6 (E.D. Ark. 1978).

80. *Id.* at 7.

was the key factor in finding the committee guilty.⁸¹ Whether civil liability may be imposed is still unanswered in Arkansas.

B. Liability Regarding a Director's Negligence in Allowing Mismanagement and Defalcations by Officers and Employees

Careless and negligent directors who have allowed mismanagement and misuse or embezzlement of corporate assets may be responsible for losses sustained by the corporation. Not only is the corporation harmed, but the shareholders, creditors, and other interested parties suffer harm as well.⁸² Some courts refer to corporate directors as trustees for their creditors in that directors are held to a high standard in performing their duties of acting in good faith and exercising diligence in handling corporate affairs in order to safeguard the interests of the creditors.⁸³ Therefore, directors may be liable to creditors for negligence in allowing mismanagement or defalcations by officers or employees.⁸⁴

If a director becomes aware of signs of mismanagement or defalcations, he is obligated to act reasonably under the circumstances from the time he is put on notice of mismanagement or defalcation to prevent maladministration or misappropriation of funds by officers and employees in order to avoid liability.⁸⁵ A director's indifference to his corporate responsibilities, which results in mismanagement or defalcation, will also subject a director to liability for negligence. However, the plaintiff must prove that the harm was caused by the negligence of the director. If a director is merely a figurehead, if an officer dominates the company's affairs, if an audit would not have disclosed the misuse of funds, if there are no signals to create suspicion of wrongful conduct, and if a director encouraged further investigation which uncovered the mismanagement or defalcation, the claimant may not be able to establish liability based on negligence.⁸⁶ By contrast, directors and officers who act as mere figureheads, may be held

81. *Id.* at 9-10.

82. See generally Rydstrom, Annotation, *supra* note 65.

83. See, e.g., *Hall v. Staha* 314 Ark. 71, 79, 858 S.W.2d 672, 676; *Raines v. Toney*, 228 Ark. 1170, 1178, 313 S.W.2d 802, 808 (1958).

84. For cases concerning directors as trustees generally and others concerning directors' liability to creditors, see, e.g., *In re Farmers Co-Op of Ark. & Okla.*, 53 B.R. 600 (W.D. Ark. 1985); *In re Ozark Restaurant Equip. Co.*, 41 B.R. 476 (W.D. Ark. 1984); *Harman v. Willbern*, 374 F. Supp. 1149 (D. Kan. 1974) (applying Kansas law), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); *Eagle Properties, Ltd. v. Scharbauer*, 807 S.W.2d 714 (Tex. 1990). See also Rydstrom, Annotation, *supra* note 65.

85. See, e.g., *Speer v. Dighton Grain, Inc.*, 624 P.2d 952 (Kan. 1981).

86. See *Department of Banking v. Colburn*, 198 N.W.2d 69 (Neb. 1972).

liable for loss of corporate funds caused by their neglect of duty to prevent or correct mismanagement or defalcations.⁸⁷

C. Liability Regarding Negligence in Allowing Property of Third Persons to be Converted by the Corporation

Although there is no privity between a director or officer and a third person, courts may impose liability on directors and officers for their negligence in allowing the corporation to convert the property of third persons.⁸⁸ The basis of liability may be ordinary negligence⁸⁹ or gross negligence,⁹⁰ and the alleged conversion may be committed by various types of businesses such as banking corporations, investment corporations, mercantile corporations, real-estate corporations, warehousing corporations, and others.⁹¹

D. Liability Regarding Issuance of Checks Against Insufficient Funds

A director or officer who participates in misdeeds perpetrated by or for the corporation involving the issuance of corporate checks against insufficient funds may be held personally liable in tort.⁹² Courts that have recognized or imposed individual liability have based their decisions on the

87. See, e.g., *Hoye v. Meek*, 795 F.2d 893 (10th Cir. 1986); *In re Western World Funding, Inc.*, 52 B.R. 743 (D. Nev. 1985), *aff'd in part and rev'd in part on other grounds sub nom. Buchanan v. Henderson*, 131 B.R. 859 (D. Nev. 1990), *rev'd*, 985 F.2d 1021 (9th Cir. 1993).

88. See, e.g., *Manville Sales Corp. v. Paramount Sys., Inc.*, 917 F.2d 544 (Fed. Cir. 1990); *Dunbar v. Finegold*, 501 P.2d 144 (Colo. Ct. App. 1972); *Taylor v. Alston*, 447 P.2d 523 (N.M. Ct. App. 1968); *Loeffler v. McShane*, 539 A.2d 876 (Pa. Super. Ct. 1988); *Olin Mathieson Chem. Corp. v. Planters Corp.*, 114 S.E.2d 321 (S.C. 1960).

See also E.T. Tsai, Annotation, *Liability of Corporate Directors or Officers for Negligence in Permitting Conversion of Property of Third Persons by Corporation*, 29 A.L.R.3d 660 (1970 & Supp. 1995) [hereinafter Tsai, Annotation].

89. See, e.g., *Loeffler v. McShane*, 539 A.2d 876 (Pa. Super. Ct. 1988); *Olin Mathieson Chem. Corp. v. Planters Corp.*, 114 S.E.2d 321 (S.C. 1960).

90. See, e.g., *Dunbar v. Finegold*, 501 P.2d 144 (Colo. Ct. App. 1972).

91. Tsai, Annotation, *supra* note 88. See also *Dunbar v. Finegold*, 501 P.2d 144 (Colo. Ct. App. 1972); *Taylor v. Alston*, 447 P.2d 523 (N.M. Ct. App. 1968); *Olin Mathieson Chem. Corp. v. Planters Corp.*, 114 S.E.2d 321 (S.C. 1960).

92. John D. Perovich, Annotation, *Personal Liability of Officers or Directors of Corporation on Corporate Checks Issued Against Insufficient Funds*, 47 A.L.R.3d 1250 (1973), [hereinafter Perovich, Annotation]. See also *Super Valu Stores, Inc. v. First Nat'l Bank*, 463 F. Supp. 1183 (M.D. Ga. 1979); *Southeastern Fin. Corp. v. Smith*, 397 F. Supp. 649 (D. Ala. 1975), *rev'd*, 542 F.2d 278 (5th Cir. 1976); *Meehan v. Adams Enters., Inc.*, 507 P.2d 849 (Kan. 1973); *Jones v. Freeman's Dairy, Inc.*, 127 N.Y.S.2d 200 (App. Div. 1954), *modified on other grounds*, 129 N.Y.S.2d 498 (App. Div. 1954); *Viajes Iberia, S.A. v. Dougherty*, 212 N.W.2d 656 (S.D. 1973).

directors' or officers' issuing, or consenting to the issuance of, checks that they knew or should have known would not be honored by the drawee banks when presented for payment by the payees.⁹³

E. Liability Regarding the Duty to Monitor How Corporate Business Is Being Conducted

Corporate directors have an obligation to oversee how the corporation's business is being conducted and to remain reasonably informed of information funnelled through the organization to the board of directors.⁹⁴ Ordinarily, this duty to monitor requires "installing or reviewing the adequacy of procedures or techniques by which salient information concerning the conduct of a corporation's business will flow to the board, or to reliable executives or third-party professionals acting on the corporation's behalf and subject to the ultimate responsibility of the board."⁹⁵

F. Liability Regarding the Duty of Care in Performing the Decisionmaking Function

Directors and officers are obligated to use due care and good faith in carrying out their corporate decisions. Fairness and reasonableness as to the substance of a business decision are relevant factors in determining due care and good faith. Alternatively, bad faith may be evidenced by a decision that is unreasonable, irrational, extreme, or motivated by personal gain.⁹⁶

93. Perovich, Annotation, *supra* note 92. See also *In re Turner*, 32 B.R. 244 (Bankr. D. Mass. 1983); *Klockner v. Keser*, 488 P.2d 1135 (Colo. Ct. App. 1971); *National Bank of Commerce v. Hughes-Walsh Co.*, 246 So. 2d 872 (La. Ct. App. 1971).

94. See Eisenberg, *The Duty of Care*, *supra* note 23, at 951-52. See also *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981) in which the court stated:

Directors are under a continuing obligation to keep informed about the activities of the corporation Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies While directors are not required to audit corporate books, they should maintain familiarity with the financial status of the corporation by a regular review of financial statements.

Id. at 822, quoted in Eisenberg, *The Duty of Care*, *supra* note 23, at 953-54.

95. Eisenberg, *The Duty of Care*, *supra* note 23, at 952.

96. Eisenberg, *The Duty of Care*, *supra* note 23, at 966-68. See also *Selheimer v. Mangonese Corp. of America*, 224 A.2d 634 (Pa. 1966); *In re RJR Nabisco, Inc. Shareholders Litig.*, No. 10389, 1989 WL 7036 (Del. Ch. Jan. 31, 1989) (applying Delaware law).

G. Additional Claims

Other civil claims against directors and officers are based on the duty of inquiry, or the duty to check out newly acquired information that signals potential corporate problems;⁹⁷ the duty owed by directors, officers, and majority shareholders of closely-held corporations in acquiring the stock of minority shareholders;⁹⁸ tortious interference with the corporation's contract with another;⁹⁹ and director and officer responsibility under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) and its 1986 amendments (SuperFund Amendments and Reauthorization Act of 1986 (SARA)).¹⁰⁰

97. See Eisenberg, *The Duty of Care*, *supra* note 23, at 956-58 (citing *Bates v. Dresser*, 251 U.S. 524 (1920)).

98. See, e.g., *Nanfito v. Tekseed Hybrid Co.*, 473 F.2d 537 (8th Cir. 1973) (applying Nebraska law); *Clayton v. James B. Clow & Sons*, 327 F.2d 382 (7th Cir. 1964) (applying Illinois law); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963) (applying Wisconsin law); *Wheatherby v. Weatherby Lumber Co.*, 492 P.2d 43 (Idaho 1972); *Jacobson v. Yaschik*, 155 S.E.2d 601 (S.C. 1967).

See also P.A. Agabin, Annotation, *Duty and Liability of Closely Held Corporation, its Directors, Officers, or Majority Stockholders, in Acquiring Stock of Minority Shareholder*, 7 A.L.R.3d 500 (1966 & Supp. 1995).

99. See, e.g., *Young v. West Coast Indus. Relations Ass'n*, 763 F. Supp. 64 (D. Del. 1991), *aff'd*, 961 F.2d 1570 (3d Cir. 1992); *Bradley v. Consolidated Edison Co.*, 657 F. Supp. 197 (S.D.N.Y. 1987); *Harrell v. Reynolds Metals Co.*, 495 So. 2d 1381 (Ala. 1986); *Payne v. Pennzoil Corp.*, 672 P.2d 1322 (Ariz. Ct. App. 1983); *Miles v. Bibb Co.*, 339 S.E.2d 316 (Ga. Ct. App. 1985); *Continental Casualty Co. v. Mirabile*, 449 A.2d 1176 (Md. Ct. App. 1982); *Burdett Radiology Consultants, P.C. v. Samaritan Hosp.*, 557 N.Y.S.2d 988 (App. Div. 1990); *Threlkeld v. Christoph*, 312 S.E.2d 14 (S.C. Ct. App. 1984).

See also Thomas G. Fisher, Annotation, *Liability of Corporate Director, Officer, or Employee for Tortious Interference With Corporation's Contract with Another*, 72 A.L.R.4th 492, §§ 3-8 (1989 & Supp. 1995) [hereinafter Fisher, Annotation].

100. Robert W. McGee, *Corporate Officer and Director Liability for Hazardous Waste: Has the Law Gone Too Far?*, 40 LINCOLN L. REV. 137 (1992). See, Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), Pub. L. No. 96-510, 94 Stat. 276 (codified at 42 U.S.C. §§ 9601-9657 (1994)); Superfund Amendments and Reauthorization Act of 1986 (SARA), Pub. L. No. 99-499, 100 Stat. 1613. For examples of Superfund cases involving corporate directors and officers, see *United States v. Northeastern Pharmaceutical & Chem. Co.*, 810 F.2d 726 (8th Cir. 1986), *cert. denied*, 484 U.S. 848 (1987); *New York v. Shore Realty Corp.*, 759 F.2d 1032 (2d Cir. 1985); *United States v. Northern Plating Co.*, 670 F. Supp. 742 (W.D. Mich. 1987), *aff'd sub nom. United States v. R.W. Meyer, Inc.*, 889 F.2d 1497 (6th Cir. 1989), *cert. denied*, 494 U.S. 1057 (1990); *United States v. Mottolo*, 629 F. Supp. 56 (D.N.H. 1984); *United States v. Wade*, 577 F. Supp. 1326 (E.D. Pa. 1983).

VII. LIMITATION MEASURES AND PROTECTIVE DEVICES FOR THE CORPORATE DIRECTOR AND OFFICER

Since directors and officers have become more vulnerable to lawsuits in recent years, many of which have resulted in liability, some measures have been taken for the purpose of "encourag[ing] initiative in enterprise decisions, encourag[ing] qualified persons to serve as directors, encourag[ing] decision-making by independent directors, and giv[ing] directors wide latitude in their handling of corporate affairs"¹⁰¹ These limitation measures and protective devices have been referred to as statutory indemnification, statutory limitations on directorial liability, and alternative insurance methods.¹⁰²

A. Indemnification Statutes

Delaware's indemnification statute, which has served as a model for most states, empowers a corporation "to indemnify any director who has 'acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation.'"¹⁰³ Parties to whom this safeguard extends include "'any person who is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise,"¹⁰⁴ if that person 'was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding.'"¹⁰⁵ New Jersey and Pennsylvania, for example, have indemnification statutes similar to that of Delaware.¹⁰⁶

The enactment of these indemnification statutes has had the effect of enlarging the range of actions for which indemnification could be provided by the corporations.¹⁰⁷ Moreover, there are three types of indemnification approaches that are applicable to directors and officers that fall within the ambit of indemnification statutes: (1) mandatory indemnification;¹⁰⁸ (2)

101. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 902.

102. *See generally Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 902-23.

103. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 903 (quoting DEL. CODE ANN. tit. 8, § 145(a) (1983 & Supp. 1991)).

104. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 903.

105. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 903.

106. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 903 (citing N.J. STAT. ANN. § 14A: 3-5 (1) (a) & (b) (West 1969 & Supp. 1992); PA. CONS. STAT. ANN. tit. 15, § 1741 (1967 & Supp. 1992)).

107. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 902.

108. Mandatory indemnification, which is automatic, is usually provided for in

permissive indemnification;¹⁰⁹ and (3) nonexclusionary indemnification.¹¹⁰ Most jurisdictions have adopted the nonexclusionary indemnification approach or some modified form.¹¹¹

Modern indemnification statutes are generally more flexible in terms of providing advance payment of legal fees and other costs prior to final adjudication of lawsuits against directors and officers.¹¹² However, such statutes may include a provision requiring the director to make reimbursement of advance payments in the event that it is decided that such payments were not warranted.¹¹³

In short, although indemnification statutes have certainly strengthened the blanket of protection around the director and officer, at least two defects have been identified. One flaw is the inability of smaller corporations to

indemnification statutes:

if a party has been successful on the merits or otherwise. In such a case, . . . [directors and officers] are not required to establish any of the necessary elements for permissive indemnification, which include acting in good faith and in a manner reasonably believed to be in the best interest of the corporation.

Turning Back the Tide of Director and Officer Liability, *supra* note 2, at 904.

109. Permissive indemnification is usually provided for in indemnification statutes covering derivative and third party actions.

Unlike mandatory indemnification, which is automatic, permissive indemnification must be authorized on a per-case basis, and such authorization requires a finding that the [party] has met the applicable standards of conduct. The requisite standards for both third party and derivative suits are separately stated within each statute, although they are similarly worded.

Turning Back the Tide of Director and Officer Liability, *supra* note 2, at 905-06.

110. Nonexclusionary indemnification or statutory nonexclusivity commonly "permits corporations to formulate their own programs for indemnification beyond the limitations of the statute. A corporate program may be established pursuant to a certificate of incorporation, shareholder resolution or a indemnification agreement or contract." *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 909. Statutory nonexclusivity or some variation of this approach has been adopted in a majority of states including Delaware, New Jersey, New York, and Pennsylvania. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 909.

111. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 909 & n.85-86, 88, 90, 93.

112. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 911.

113. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 911 & n.102 contain an example of Delaware's reimbursement proviso. Delaware's amended statute provides:

Expenses (including attorneys' fees) incurred by an officer or director in defending any . . . suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified by the corporation as authorized in this section.

Turning Back the Tide of Director and Officer Liability, *supra* note 2, at 911 (DEL. CODE ANN. tit. 8, § 145(e) (Supp. 1991)).

afford to indemnify a director because of lower capital. Another flaw is the failure of such statutes to excuse the personal liability of a director for a breach of a duty of care despite the director's good faith.¹¹⁴

B. Liability Limitation Statutes

In view of the flaws in statutory indemnification statutes stated previously, state statutes have been enacted empowering corporations to adopt policies restricting or eliminating directors' and officers' personal liability for "breaching their duty of care."¹¹⁵ Delaware, for example, added a liability limitation clause to its corporation law authorizing a corporation to include in its certificate of incorporation or charter a provision

eliminating the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall *not* eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith of which involve intentional misconduct or a knowing violation of law, (iii) [for improper distributions], or (iv) for any transaction from which the director derived an improper personal benefit.¹¹⁶

Note that the preceding proviso only applies to directors, and the stockholders of a corporation must approve such a proviso as an amendment to the certificate of incorporation or charter. Delaware's statute is quite popular and has served as model legislation for over thirty other states.¹¹⁷

114. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 912.

115. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 912-13.

116. Eisenberg, *The Duty of Care*, *supra* note 23, at 970 & n.70 (citing DEL. CODE ANN. tit. 6, § 102(b)(7) (Supp. 1988)). See also *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 914-15; Eisenhofer, *Officers' and Directors' Liability*, *supra* note 28, at 68.

117. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 914 & n.124 (citing directorial liability limitation provisos adopted by 32 states using Delaware's statute as a model or paradigm).

C. Alternative Insurance Methods

Indemnification statutes of almost all states allow corporations to procure liability insurance for corporate directors and officers.¹¹⁸ Again, Delaware law has served as model legislation for most states which promote the purchase and maintenance of insurance for directors and officers unless restricted by public policy, as in the case of "willful or intentional wrongdoing, fraud or knowing violation of law."¹¹⁹ The Delaware statute stipulates that "[a] corporation shall have the power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent . . . whether or not the corporation would have the power to indemnify him against such liability under this section."¹²⁰ Although this legislation permits the lessening or offsetting of indemnification by corporate insurance funding, it is subordinate to state insurance laws that limit or restrict coverage for certain behavior that is against public policy.¹²¹

Since directors and officers benefit from insurance programs in ways that are not available through indemnification or liability limitation statutes, more and more corporations are considering replacing conventional commercial insurance policies or increasing their existing insurance coverage.¹²² Some alternative insurance methods employed by corporations include captive insurance company agreements, insurance pooling arrangements, fronting arrangements, trust agreements, and self-insurance programs.¹²³ Usually, one or more of these alternatives are utilized in combination with charter-provided indemnification or with a separate indemnification agreement that contains specific contract protection for directors and officers.¹²⁴

118. See *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 917. Vermont was identified as a state that does not have legislation authorizing liability coverage for directors and officers. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 917 n.148.

119. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 917 & n.150 (citing public policy prohibitions).

120. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 917 & n.149 (citing DEL. CODE ANN. tit. 8, § 145(g) (1983 & Supp. 1991)). For a comparison of Delaware's statute to other state statutes see *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 918.

121. See *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 917-18.

122. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 919.

123. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 919-23.

124. *Turning Back the Tide of Director and Officer Liability*, *supra* note 2, at 919-20 & n.168.

D. Other Defenses

Limitations on director liability for mismanagement or defalcations by officers or employees have been asserted to refute corporate losses where a director was excused from the performance of active duties, where a director relied upon officers or employees, and where a director relied upon other directors.¹²⁵ If a director is excused from his corporate duties during the time that the corporation experiences financial losses, he may be absolved of liability for alleged negligence.¹²⁶ Furthermore, if a director relies on officers, employees, or other directors, he may not be liable for alleged negligence in permitting the wrongful acts of such persons.¹²⁷

125. Rydstrom, Annotation, *supra* note 65, §§ 22-23 (citing, e.g., *Harmon v. Willbern*, 374 F. Supp. 1149 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963); *Taylor v. Alston*, 447 P.2d 523 (N.M. App. 1968); *King v. Bullard*, 643 S.W.2d 457 (Tex. Ct. App. 1982), *aff'd in part and rev'd in part on other grounds*, 652 S.W.2d 767 (Tex. 1982)).

126. See, e.g., *Harmon v. Willbern*, 374 F. Supp. 1149 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975) (applying Kansas law).

127. See, e.g., *Graham v. Allis-Chalmers Mfg., Co.*, 188 A.2d 125 (Del. 1963); *Taylor v. Alston*, 447 P.2d 523 (N.M. Ct. App. 1968); *King v. Ballard*, 643 S.W.2d 457 (Tex. Ct. App. 1982), *aff'd in part & rev'd in part on other grounds*, 652 S.W.2d 767 (Tex. 1982).

